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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1974.

**No. 74-1042**

ERNST & ERNST,

*Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL.,

*Respondents.*

ERNST & ERNST,

*Petitioner,*

*vs.*

LEON S. MARTIN, ET AL.,

*Respondents.*

## ANSWER OF RESPONDENTS ALLISON, CARNOVSKY, DRAKE AND JACKSONS TO PETITION FOR A WRIT OF CERTIORARI.

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March 22, 1975.

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## ANSWER OF RESPONDENTS ALLISON, CARNOVSKY, DRAKE AND JACKSONS TO PETITION FOR A WRIT OF CERTIORARI.

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This answer to the petition for a writ of certiorari is filed on behalf of respondents Helen Allison, Leon N. Carnovsky, Zerah A. Drake, Elizabeth B. Jackson, John M. Jackson, Trustee, and John M. Jackson, Individually, Escrow Claimants.

Certiorari should be denied for the following reasons:

1. *This action is not ripe for review by this Court.* The Court below reversed an order granting summary judgment

in favor of petitioner, Ernst & Ernst and against respondents, the escrow claimants. The matter as it stands will go back to the District Court for trial on the merits. It comes to this Court now simply on the pleadings, depositions, affidavits and counter-affidavits. For the reasons stated more fully below, a party's liability under § 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder can scarcely be spelled out in the abstract as petitioner would have this Court do. It makes a difference, it seems to us, whether liability is sought to be imposed on an auditor (as here), or an issuer, or an underwriter, or a broker, or someone else. If this is true, then we think it follows that the question of § 10(b) and Rule 10b-5 liability ought to be considered on the basis of a full record. This Court should have before it the full facts of the claimed audit deficiencies, and the opinion of experts thereon. A wiser judgment can be fashioned on such a record than on the skimpy record now at bar.

2. *Petitioner has conjured up circuit conflict where none exists in fact.* It is elementary that court decisions must be read in the light of the facts at bar. In disregard of this principle, petitioner asserts that there is a conflict between the case at bar, which involves § 10(b) aiding and abetting liability arising out of audit deficiencies, and cases in the Second Circuit against a broker for failure to sell promptly, *Shemtob* (Pet. p. 9); and against an independent director for false representations made by officers in connection with an acquisition, *Lanza* (Pet. p. 10); a case in the Sixth Circuit involving an injunction action against an issuer and its officers for false statements (*SEC* v. *Coffey* (Pet. p. 11)); and a case in the Tenth Circuit against a seller of a security (*Clegg* v. *Conk*, 507 F. 2d 1351 (1974)). Petitioner evidently has misread *Clegg*, because the District Court there was affirmed and not reversed as petitioner implies, (Pet. p. 12).

The Court below carefully analyzed the issue before it. It began with a discussion of its prior decision in *Hochfelder* v.



*Midwest Stock Exchange*, 503 F. 2d 364 (7th Cir. 1974), *cert. den.*, ..... U. S. ....., 42 L. Ed. 2d 114 (1974). In *Midwest* plaintiffs sought recovery against Midwest Stock Exchange for the same loss sued on here, and asserted liability against Midwest for failure of its duty of proper supervision of First Securities. The Seventh Circuit, basing its holding here on its prior holding (see 503 F. 2d at 1104), fashioned a "flexible standard of liability." It held that a claim for aiding and abetting liability is established where it is shown:

> "(1) that the defendant had a duty of inquiry; (2) the plaintiff was a beneficiary of that duty of inquiry; (3) the defendant breached the duty of inquiry; (4) concomitant with the breach of duty of inquiry the defendant breached a duty of disclosure; and (5) there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud; that is, adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention."

The Court, applying its standard, observed that First Securities had a statutory duty under § 17(a) of the 1934 Act, 15 U. S. C. § 78q(a), to secure a certified audit on SEC Form X-17A-5 and to file it with the Securities Exchange Commission. For many years First Securities retained Ernst & Ernst to undertake this work and file the required certified statement. Hence Ernst & Ernst had a "statutory duty of inquiry." (503 F. 2d at 1105) This duty, the Court held, inured to the plaintiffs, 503 F. 2d at 1105, since the SEC is specifically directed by § 17(a) to prescribe reports and records "necessary or appropriate in the public interest, or for the protection of investors." With respect to the question whether Ernst & Ernst breached its duty, the Court held (a) that the standard of conduct was the standard of care expected of persons holding themselves out as skilled accountants, and (b), that Form X-17a-5 expressly requires a review of the accounting system, the internal accounting control, and procedures for safeguarding securities. Ernst & Ernst was required to "substantiate the assets and liabilities" so as to

permit an opinion as to the "financial condition" of First Securities. (503 F. 2d at 1107-8)

Ernst & Ernst does not dispute the facts to which the above rules are to be applied. During all the 19 years that Ernst & Ernst audited First Securities, the president of the firm, Leston B. Nay, had a rule that all mail addressed to him personally or addressed to the firm but to his attention, was not to be opened in the company's mail room but was to be delivered to him unopened. When he was away from the office such mail was placed on his desk unopened, regardless of the duration of his absence from the office.

In June 1968, Nay shot his wife, and committed suicide. He left a suicide note which revealed that for many years he had engaged in a series of frauds and embezzlements: respondents here, customers of First Securities, were swindled out of $972,500 through a false "escrow" scheme.

Shortly after the suicide, the SEC initiated an equity receivership against First Securities which was then insolvent due to Nay's frauds. After litigation, the claims of the escrow claimants were allowed against First Securities on the ground that it aided and abetted the fraud. (*SEC* v. *First Securities of Chicago*, 463 F. 2d 981 (7th Cir. 1972), *cert. den.*, 411 U. S. 972 (1973)) In addition to defrauding the escrow claimants, Nay embezzled from Mrs. Nora Moyer $175,000 in securities left for safekeeping with First Securities, $394,000 from Arnold Scheueren, and $17,000 from Mrs. Scheueren. The Scheueren claims were allowed after litigation. (*SEC* v. *First Securities of Chicago*, 466 F. 2d 1035 (7th Cir. 1972), *cert. den.*, 409 U. S. 1041 (1972))

Nay's mail rule, respondents assert, was the key to concealment of these frauds. 503 F. 2d at 1109. In the District Court, the escrow claimants presented affidavits by certified public accountants to the effect that had they audited a firm with such a rule they would not have certified the audit, or would have expressed a qualified opinion.



In light of the above, the Seventh Circuit held, 503 F. 2d at 1111, that the fact issues for trial are: (1) whether the mail rule constituted a material inadequacy in First Securities' system of internal control, and (2) whether Ernst & Ernst failed to exercise due care in that it did not discover a "material inadequacy in internal accounting control."

Thus the case at bar does not present the simplistic issue framed by Ernst & Ernst. Rather, the holding of the Court below that the complaint states a cause of action for aiding and abetting under § 10(b) is firmly grounded on the 1934 Act. Indeed, apart from § 10(b), the basic fact that Ernst & Ernst undertook the § 17(a) audit required of First Securities, and failed to perform the audit with due care, by itself seems adequate to impose liability. Section 17(a), it seems clear, imposes implied liabilities just as § 14(a) does. Cf. *J. I. Case Co.* v. *Borak*, 377 U. S. 426 (1964).

3. *On the basic issue presented, auditor liability, the cases are in substantial accord. There is no real circuit conflict.* It is significant that Ernst & Ernst does not cite a single case relating to the liabilities of accountants under the federal securities laws. The reason may be that the cases are in substantial harmony with the Seventh Circuit. Thus, in *Heit* v. *Weitzen*, 402 F. 2d 909 (2nd Cir. 1968) the Second Circuit held that a § 10(b) complaint against an auditor stated a cause of action where it alleged that the auditor, when certifying financial statements, "knew or should have known" that they were incorrect. 402 F. 2d at 914. Plaintiff had purchased debentures after the statements had been disseminated to the public. The Seventh Circuit decision at bar was preceded by *Drake* v. *Thor Power Tool Co.*, 282 F. Supp. 94 (D. C. Ill. 1967), holding that a purchaser of stock could maintain a § 10(b) action against an auditor for applying inappropriate accounting procedures with respect to the Thor audits. In *Fischer* v. *Kletz*, 266 F. Supp. 180 (N. Y. 1967), an auditor was charged with aiding and abetting a § 10(b) violation by failing to disclose promptly inaccuracies in an earlier audit. The auditor's motion to dismiss

was denied and the case held for trial. Cf. *Escott* v. *Bar Chris Const. Co.*, 283 F. Supp. 643, 697, 703 (N. Y. 1968). (Auditor held liable under § 11 of the Securities Act of 1933 where it failed to sustain its "due diligence" defense under § 11(b)(3).) See also, as to common law liability of an auditor, *Rusch Factors, Inc.* v. *Levin*, 284 F. Supp. 85 (R. I. 1968).

4. *The other issues presented by petitioner are insubstantial.* The foregoing disposes of petitioner's points 1 and 4.

As to Point 2: the question whether the statute of limitations has been tolled, is an issue that necessarily must be decided in the light of the peculiar circumstances of each case. Here, the Seventh Circuit held that where the acts of a defendant facilitate the perpetration of a concealed fraud of another, the bar of the statute does not run until the fraud is discovered or should have been discovered. 503 F. 2d 1119. Ernst & Ernst admits the action was brought within three years of the discovery of the fraud. It is difficult to envision a decision on the tolling question that would be of general value.

The precise issue under the federal securities laws appears to have arisen only once before, and then in another phase of this same case. See the Seventh Circuit's decision in *Hochfelder* v. *Midwest Stock Exchange*, 503 F. 2d 364, *cert. den.*, ..... U. S. ....., 42 L. Ed. 2d 114 (1974).

In *Cato*, Pet. p. 17, a Railway Labor Act case, the courts held simply that a misrepresentation by one defendant is not imputed to another. No such rule is contended for here. Indeed the District Court in *Cato* recognized the concealed fraud rule. 364 F. Supp. at 493.

*Detroit* v. *Grinnell* (Pet. p. 18) is not a holding per se on a limitations question but an appeal from court approval of an antitrust settlement. The Court, moreover, spoke of concealment by the defendants because such was the situation before it. It had no occasion to distinguish between defendants and others. In *General Electric* (Pet. p. 18) likewise the Court spoke of concealment by a party since the tolling question arose on such facts.



Petitioner's issue No. 3 has even less to commend it: Ernst & Ernst asks this Court to hold that, as a matter of law, before a trial on the merits, it is entitled to a judgment that the escrow claimants failed to exercise due diligence in uncovering the fraud and that consequently they cannot rely on the doctrine of fraudulent concealment to toll the Statute of Limitations. Further, they ask this Court for a similar judgment, without a trial on the merits, as to whether the escrow claimants are estopped by knowledge and conduct to assert their claims. These issues are clearly fact issues. Even when dressed with a veneer of legal issues, they fail to present issues for this Court. Ernst & Ernst claims no circuit conflict—the questions are so specialized there hardly could be such conflict. Indeed, Ernst & Ernst cites no cases whatever respecting the point.

Respondents respectfully submit that certiorari should be denied.

Respectfully submitted,

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